

SEVEN FINANCIAL HABITS OF SUCCESSFUL COMPANIES

Vincent Reynolds offers advice on how to survive, and thrive, in tough times

Businesses exist primarily for a single reason: creating wealth for their owners, the shareholders. They do this by selling goods and services at a price that is greater than the cost of producing those goods and services. This simple reality applies to businesses in all sectors, whether they are a manufacturing company, an energy utility, a professional services firm, or a film studio. There are just two levers a business manager can pull in order to increase profitability: increase revenue or reduce costs. The clever ones are able to pull both levers at once. The really clever ones can do so while, at the same time, converting profits into cashflow that will sustain the business. The really, really clever ones can do all of this during tough times, times such as the ones we live in now, with wobbly financial markets and jittery economic forecasts the order of the day. The following seven financial habits could mean the difference between success and failure for a business operating during these tough times.

Habit no 1: recognise that not all revenues are equal
More than a century ago, Alfredo Pareto first popularised the Pareto (or 80/20) Rule, an age-old simple rule-of-thumb assumption that recognises that a disproportionately large number of effects stem from a small number of causes. While Pareto focused on the fact that 80% of a nation's wealth appeared to be owned by 20% of its inhabitants, the assumption can be applied to business applications. Very often 80% (or some other high percentage) of our revenue (and profits) will stem from 20% of our customers. Similarly, often 80% of revenues and profits will stem from 20% of the products or services in our product/service portfolio. In tough times, it is more important than ever to single out the customers and products that can most critically impact your business. Financially effective companies scrutinise where their most important revenues and profits are coming from and act to protect and grow them. Losing one key customer in a

recession can spell death for a business. At the same time, successful companies look at the 80% of customers (and products) that make up 20% of revenue and make tough decisions about which ones they will deprioritise or even drop. The adage 'revenue is vanity, profit is sanity' comes to mind here. Successful companies ask: 'how can we focus on the revenue that will generate best profits for our business?'

Habit no 2: know the magic of margin
An early mentor in my career drummed into me that margin was the key to a profitable business. Put simply, gross margin is the difference between the revenue generated by goods and services and the direct costs (materials, labour, freight and other costs that can be traced directly to the products/services sold) of generating those revenues. Why is it so important? Well, margin is what is used to pay for everything else that needs to be deducted from revenue in order to leave a profit for shareholders. Therefore, it needs to cover overheads (costs, mainly fixed in nature, that cannot be directly traced to units of product or services sold) as well as interest and tax. Since overheads are predominantly fixed in the short-term, every extra percentage point in gross margin can boost the bottom line. A company with revenues of €100m and net profit of €10m can, all things being equal, boost its bottom line by 10%, or €1m, as a result of just a 1% increase in gross margin. That is the magic of margin. Financially effective companies look at how they can increase margin by improving sales mix (back to Pareto, shifting more high-margin products) or by reducing input costs, such as the cost of materials, direct labour, packaging and freight. Another key way to influence margin is to educate everyone in your organisation as to how margin and its constituent parts work. In this way, sales people, for example, can bring a new level of financial discipline to how they offer discounts to customers. Every percentage point given away in discount is a percentage point taken away from profitability. And every percentage point matters in times of tough economic conditions. It is far better

to find ways to differentiate the product and service offering to create value, rather than acting like a commodity broker trading solely on price.

Habit no 3: cut cost but not value
The natural tendency in straitened times is to cut cost out of the operation. Sometimes, this may be done arbitrarily. Arbitrary cost-cutting can damage the long-term sustainability of a business. Consider a technology company with a €10m R&D budget. Laying off half of those engaged in R&D may take €5m out of the immediate cost base but what are the long-term implications? Such a move could leave the business with a weakened pipeline of new products and features, along with a vulnerability to lost software development talent when the economy moves into upswing mode. This means that the company may not be able to compete. And companies not able to compete either go out of business or are snapped up by predatory competitors better able to exploit opportunities in the marketplace. Management consultant Tom Peters famously said that an organisation cannot 'cut its way to success'. True, in tough times it is very necessary to challenge every item of cost in the income statement but only after considering very carefully, the implications for long-term shareholder value. Effective managers realise this and focus not just on taking cost out but in putting value into the business operations.

Habit no 4: develop 'cost agility' skills
A high level of fixed costs can drag a profit-making company into loss during a downturn in the business environment. Fixed costs are just that – fixed – and cannot easily be taken out of the business without painful reorganisation and restructuring. Those companies that recognise that there is a strong need for 'cost agility', achieving an optimum balance between fixed and variable costs, will have the upper hand when they need to 'cut their cloth to their measure' during difficult times. One of the ways to do this is to think about which costs

can be outsourced. Outsourcing can have the effect of taking a chunk of fixed costs – for example, an IT department – and putting it outside the organisation in the hands of a vendor that has IT as its core expertise. A service-level agreement can be negotiated that links payment to both a fixed monthly charge and a variable charge, based on usage or volume of activity per month. In this way, a fixed cost can be switched to a combination of a fixed and variable cost, one that is linked to actual business activity levels. The other key benefit, of course, is that outsourcing allows the company to focus all of its energies on bringing value to its customers via its core products and services. This level of focus will be especially important during tough times.

Habit no 5: invest wisely in new projects

A natural tendency of companies during a recession is to pull up the drawbridge, protect cash, and not venture forth into the highly dangerous world of new investments. Yet, none other than the Sage of Omaha, Warren Buffet, has said that when the waters are dangerous that is the very time to move in to pick up bargains and value. For a business intent on creating sustainable value for its shareholders, there is never a time when business-worthy investments should not be considered. The key thing is to create a business case process that will allow investment opportunities to be fully evaluated before committing cash and resources to them. Well-managed companies evaluate such things as opening a new sales office in the Middle East; acquiring an ailing competitor; or investing in a new product or process, all in the light of the overall business strategy. Managers at all levels should be able to understand, in simple terms, the financial consequences of adopting such a proposal. They will have a format for answering such questions as: what will the return on investment be?; how long will it take to pay back its initial outlay?; does it have a positive net present value?; and, does the internal rate of return meet our company's cost of capital? There is no need for these topics to be the vocabulary of just the accountants and MBA graduate members of the management team, rather they can easily become part of the vernacular of all decision-makers within the company.

Habit no 6: question everything

In Ireland, we have a concept in our educational system called the 'transition

year'. The transition year is mid-way through the secondary school curriculum, around age 15 for most students. In transition year, students spend 12 months outside of the conventional education system working on projects, getting work experience in commercial enterprises and participating in other activities that will broaden their experience of the world before they return for their final two years of school. Often, when I am consulting for companies intent on improving their financial performance, I ask management: 'what would a bunch of transition year students recommend if they were to come in here for a few months?' Many times I am met with blank stares when I ask this question but I feel that the very naivety of these kids can be a natural counterfoil to the 'we've always done it this way' attitude that can take hold in many companies. Successful companies in a downturn ask themselves: if we were starting the business today, what would we do differently?; how would we simplify how we do business?; what should we start doing?; what should we stop doing?; and, most tellingly of all, what single thing should we do differently that would have the greatest positive impact on our financial performance? Another version of this exercise is to ask management: if a predatory competitor were to take us over tomorrow, what would they change?; what cost would they take out of the organisation?; how would they reshuffle how we do business?; what waste would they identify?; and, how would they eliminate it? It is by continuously challenging the status quo, and by continuously questioning what we do, that we can protect our business from the fog of complacency and the hubris borne of past successes.

Habit no 7: make everyone in the organisation a financial expert
Finance is often left in the hands of the 'financial experts', i.e., the accountants. However, almost everyone in an organisation is capable of understanding the fundamentals of finance, in so far as they apply to the business of the organisation. Finance is a language, not an abstract concept. It is only by teaching everyone in the organisation the language of finance that we can create the 'joined-up thinking' that can ensure our financial success. This should start with an induction programme that explains how exactly the company makes its money. Concepts as crucial as profitable revenue growth; optimising gross profit margin; eliminating wasteful

overheads; and, generating cash from every aspect of the business are not topics for the exclusive consideration of the CFO and the senior management team. These concepts should be explained in simple terms and socialised at every level of the business. Nowhere is this more critical than in the case of those professionals and managers whose actions will have the power to commit the company to potentially expensive courses of action – buyers, sales professionals, R&D managers managing multi-million euro projects, HR managers recruiting key talent, an IT manager deciding whether to outsource – since those managers will ultimately decide the profitability (and viability) of the organisation. In-house financial acumen and business acumen training should cover the basics of how the company competes and how it makes money and manages its profits, balance sheet and cash. Every single person within the company should understand how their efforts link to the ongoing viability and success of the company.

Performing

The seven habits can help a business, not only to survive, but to thrive in an economic downturn. They can also help a business to achieve excellent results in times of prosperity. What each of these habits comes down to, at the end of the day, is common sense. But we all know the problem with common sense: it's not so common! Effective companies in a downturn constantly ask: which products or services should we be pushing?; how are our margins performing?; how can we reduce costs without eroding value to our business, and to our customers?; how can we create cost agility/flexibility?; how can we be sure we are investing in the right things?; what would we do if we were starting over in this business?; and, finally, how can we educate all of our staff in the key skills of financial acumen? By asking questions such as these, companies can help ensure that they create sustainable value for their shareholders. In doing so, they will ensure that the company not only rides out the tough times, but is also ready to participate fully in the recovery that inevitably follows a downturn.

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